

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**



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Application of California-American Water Company (U 210 W) for an Interest Rate of 8.33% for Allowance for Funds Used During Construction (AFUDC) for its San Clemente Dam Memorandum Account and for Authorization to Place the Estimated Annual Average cost of Construction Work in Progress into Rate Base Once the Project is More Certain.

Application No. 07-02-023
Filed February 20, 2007

**CALIFORNIA-AMERICAN WATER COMPANY'S REPLY TO PROTESTS OF THE
DIVISION OF RATEPAYER ADVOCATES AND MONTEREY PENINSULA WATER
MANAGEMENT DISTRICT**

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Pursuant to Rule 2.6(e) of the Rules of Practice and Procedure for the California Public Utilities Commission ("Commission"), California-American Water Company ("California American Water") hereby submits this reply to the *Protest of the Division of Ratepayer Advocates*, ("DRA's Protest") and the *Protest of the Monterey Peninsula Water Management District* ("MPWMD's Protest"), both filed on March 26, 2007, to Application 07-02-023, California American Water's Allowance for Funds Used During Construction (AFUDC) proposal for its San Clemente Dam Project. California American Water's Application provides detailed and substantial evidence supporting its request for authorization to (1) accrue AFUDC at the Monterey District's current authorized rate of return on its San Clemente Dam Memorandum Account; and (2) place the estimated annual average cost of Construction Work in Progress (CWIP) into rate base once the Environmental Impact Report (EIR) for the San Clemente Dam Project is certified, or when some other specified milestone is reached indicating that the Project is more certain.

As described herein, DRA's and MPWMD's grounds for protest are misplaced. In their Protests, DRA and MPWMD provide no new evidence, fail to address the issues in the

proceeding, and most importantly, DRA and MPWMD fail to address the impact of their proposal on customers and California American Water.

I. COMMON ISSUES RELATING TO DRA’S AND MPWMD’S PROTESTS

This Reply will respond to common issues relating to DRA’s and MPWMD’s Protests collectively and then address the Protests separately on other issues. DRA and MPWMD both commented on the following issues: (A) setting the interest rate of AFUDC for California American Water’s San Clemente Dam memorandum account at the 90-day commercial paper rate rather than California American Water’s currently authorized rate of return; (B) the appropriateness of placing California American Water’s estimated annual average cost of CWIP into rate base before the Project is completed. DRA’s and MPWMD’s recommendations to limit AFUDC to the 90-day commercial paper rate and delay CWIP ratemaking treatment of the Project investment ignore the very real impact of these actions upon customers and California American Water. This Reply responds to each of these issues below.

A. California American Water’s Proposal Will Benefit Customers and the Company.

1. California American Water’s Proposal to Use a Full, Weighted Cost of Capital as the AFUDC Carrying Cost Will Benefit California American Water and Its Customers.

Both DRA’s and MPWMD’s proposals wholly ignore evidence that using a full, weighted cost of capital as the AFUDC carrying cost will benefit the company and its customers. In stark contrast, DRA’s and MPWMD’s proposal to limit the AFUDC rate to a level lower than California American Water’s actual cost of the financing will make the investment more risky and affect the overall cost of capital of the company, thereby increasing the financing cost for all of the company’s investments. Thus, DRA’s recommendation to set the AFUDC rate below the actual cost of Project financing is short-sighted and will affect California American Water’s ability to attract capital in the long-term and raise the cost of capital paid by all of California American Water’s customers.

Additionally, DRA and MPWMD ignore the large capital investment needs that both California American Water and the industry face in California, and the Commission's recognition of those requirements in its Water Action Plan. (Water Action Plan, p. 4.) Maintaining the current disincentive for investment caused by the inadequate AFUDC return is exactly contrary to supporting those needed investments. While the Commission will determine as a result of this proceeding an AFUDC carrying cost and potential CWIP treatment only for one substantial project for California American Water, the outcome will send a signal to the water industry about the Commission's willingness to compensate utilities for the expense of investments necessary to the welfare of customers.

2. California American Water's Proposal for CWIP Ratemaking Treatment Will Protect Both California American Water and Its Customers.

In their Protests, DRA and MPWMD fail to address how their proposal to delay CWIP ratemaking treatment will address the customer impacts of delaying recovery of the cost of capital for large capital projects. California American Water's proposal to move the San Clemente Project costs from AFUDC to CWIP as soon as possible will benefit both customers and the company. Limiting the duration of AFUDC treatment on the Project investment and then using CWIP will smooth capital cost recovery, mitigate the rate spike in the cost of service and reduce the total dollar amount customers will ultimately pay in rates.

DRA's position is inconsistent with the Commission's preference to place all CWIP for water utilities in rate base as the status of a proposed long-term project becomes more certain. (See D.03-02-030, 2003 Cal. PUC LEXIS 121.) The San Clemente Dam Project is comparable to other major capital projects for which the Commission has authorized CWIP ratemaking treatment and will benefit customers and the utility. The Commission has specifically recognized that accounting for the San Clemente Dam seismic safety project investments as CWIP in rate base would provide protection to both California American Water and its customers. (See D.03-02-030, **62-63.)

B. The AFUDC Rate for California American Water's San Clemente Dam Memorandum Account.

DRA's and MPWMD's Protests wholly disregard the fact that the Commission directed California American Water in D.06-11-050 to file an application addressing the AFUDC methodology that should be applied to the memorandum account. (D.06-11-050, 2006 Cal. PUC LEXIS 479, *167, Ordering Para. 19.) Implicit in that directive is a recognition that the 90-day commercial paper rate would be inadequate to compensate California American Water for the carrying cost of the San Clemente Dam Project and that the AFUDC rate should be set at something higher than the existing 90-day commercial paper rate. The position of DRA and MPWMD that California American Water should only be allowed to accrue AFUDC for the San Clemente Dam Project at the 90-day commercial paper rate is unfounded.

1. The Proper Carrying Cost Should Reflect the Risk of the San Clemente Dam Project.

Contrary to DRA's claim that the Commission cannot set the AFUDC rate at California American Water's currently authorized rate of return because the project scope is still uncertain, this is precisely the reason that the Commission should calculate the AFUDC rate based upon the actual cost of financing the San Clemente Dam Project rather than the 90-day commercial paper rate. The 90-day commercial paper rate, which is paid by capital markets for a short-term investment of very low risk, is too low. As California American Water explained in its Application, the San Clemente Dam Project investment is more risky than is California American Water's overall investment in rate base because of the uncertain scope of the project and therefore discounting the carrying cost of a project will create a disincentive for investment that will ultimately harm California American Water and all its customers. In D.06-11-050, the Commission recognized that an AFUDC interest rate that reflects California American Water's long-term debt and equity, similar to what is used for energy projects, should be more appropriate for California American Water because it "will need to obtain financing over several years for the project." (D.06-11-050, *67.)

2. The Commission Decisions Cited By DRA and MPWMD in No Way Preclude the Commission From Adopting California American Water's Proposed AFUDC Rate of 8.33 Percent.

DRA and MPWMD incorrectly claim that prior Commission decisions somehow require the Commission to adopt the commercial paper rate for accruing a return on California American Water's San Clemente Dam memorandum account. DRA and MPWMD cite to D.03-09-022 in support of their position that the 90-day commercial rate should be applied.¹ However, that case did not overturn D.03-02-030. Rather, it explicitly preserved CWIP ratemaking for the Carmel River Dam, which had been adopted in the prior decision along with CWIP for the San Clemente Dam Project. Conclusion of Law 3 states: The Commission should not modify the ratemaking treatment adopted in D.03-02-030 for the Carmel River Dam costs." (D.03-09-022, *41.)

Moreover, D.03-09-022 did not overturn the Commission's prior authorization of CWIP treatment of the San Clemente Dam Project. Contrary to DRA's and MPWMD's claims, D.03-09-022 was a case-specific determination of the ratemaking treatment for a particular project, not a rulemaking or determination of policy for all water company investments. In deciding how California American Water's Coastal Water Project should be treated, the Commission opted not to provide either CWIP or AFUDC as the utility's cost of capital because physical construction had not begun. The distinction in D.03-09-022 between short- and long-term projects is not relevant to determining the appropriate AFUDC rate that should apply to the San Clemente Dam. Indeed, the San Clemente Dam Project is entirely different from the Coastal Water Project, particularly with regard to the status of the Coastal Water Project at the time the Commission issued D.03-09-022. With respect to the San Clemente Dam Project, the physical work is part of the current expenditures and there is no doubt that a project will have to be undertaken by California American Water to make the dam seismically safe. The only uncertainty is the scope of the Project (dam thickening, bypass, or removal).

¹ D.03-09-022 (2003), 1997 Cal. PUC LEXIS 1279. DRA also cites to earlier decisions (D.00-03-053 and D.94-06-033) that are irrelevant to the Commission's determination of the issues in this proceeding.

Furthermore, D.03-09-022 and other decisions cited by DRA were available to the Commission (and considered by the Commission) when it issued D.06-11-050 and ordered California American Water to file the Application that is the subject of this proceeding. Clearly, the Commission does not consider D.03-09-022 to have addressed the issue.

Finally, even if the Commission's prior determination on the interest rate for a different capital project (California American Water's Coastal Water Project) could be considered relevant to the San Clemente Dam Project, despite the clear differences in the projects, the Commission is not bound by its prior precedent. (*In re Pacific Gas & Electric Co.* (1988), 30 CPUC.2d 189, 223-225; citing *Postal Telegraph-Cable Company v. Railroad Commission of the State of California* (1925), 197 Cal. 426, 436-37 ("Circumstances peculiar to a given situation may justify such a departure.")) In any event, California American Water has demonstrated that the circumstances surrounding the San Clemente Dam Project are different from those of the Coastal Water Project, and that the San Clemente Dam circumstances warrant an AFUDC rate of California American Water's current authorized rate of return.

C. The Commission Should Grant California American Water's Request to Place Its Estimated Annual Average Cost of CWIP Into Rate Base Once the Project Becomes More Certain.

1. Commission Precedent Supports California American Water's Request to Place Its Estimated Annual Average Cost of CWIP Into Rate Base Once the Project Becomes More Certain.

Without any justification or explanation, DRA argues that California American Water should not be allowed to place its estimated annual average cost of CWIP into rate base until the investment in plant is used and useful. (DRA's Protest, p. 3.) Contrary to DRA's claim, California American Water's request to place its estimated annual average cost of CWIP into rate base once the actual physical Project becomes certain is consistent with Commission precedent. The Commission has previously recognized "special circumstances warranting a departure from standard ratemaking practice, which allows project costs to be included in rates only after the project is found to be 'used and useful.'" (D.06-12-040, *33.)

DRA argues that due to the uncertainty of the Project California American Water should not be allowed to place the Project costs in rate base until the Project is complete. As set forth in the Application, California American Water has already addressed that concern by seeking authorization to begin recovering its costs in rate base only after the Project is significantly more certain, as evidenced by California American Water reaching a significant milestone, such as when the EIR for the Project is certified. DRA's argument that it would be inappropriate to provide CWIP ratemaking treatment before the Project has been completed because it could not complete the final reasonableness review of all related expenditures is meaningless. DRA will be provided with the opportunity to fully review the Project costs before the expenditures are placed in plant in service.

Similarly, DRA's claim that California American Water's request is precluded by the principle of res judicata under D.06-11-050 is wholly unfounded. In that decision, the Commission expressly recognized that California American Water could seek to recover in rate base its estimated Project costs once "the Commission has fully reviewed a final project proposal, either in the next GRC or by separate application if Cal-Am is ready to proceed before its next GRC." (D.06-11-050, **64-65.)

II. PROTESTS TO THE APPLICATION

This Reply will respond to the key points in the Protests not already addressed in Section I above.

A. DRA's Protest

1. California American Water Does Not Object to DRA's Revised Procedural Schedule.

Although California American Water seeks to expeditiously resolve the issues in this proceeding, it does not object to the modified procedural schedule proposed by DRA in its Protest. To accommodate scheduling conflicts, California American Water also requests that the

procedural schedule be pushed out one week beginning with the deadline for the utility rebuttal testimony.²

DRA's proposed delay to the procedural schedule is acceptable to California American Water because the Commission authorized California American Water to accrue AFUDC at the 90-day commercial paper rate, subject to true up, until the review of the AFUDC rate is completed. At the time of the final decision approving the AFUDC rate, California American Water will true up the AFUDC for the period beginning November 30, 2006, the effective date of the decision ordering California American Water to file the Application, to account for the difference between the AFUDC rate approved and the 90-day commercial paper rate.

B. MPWMD's Protest

1. The Commission Has the Requisite Authority to Approve California American Water's Proposal to Move AFUDC to Construction Work in Progress as Part of This Proceeding.

In its Application, California American Water sought approval to move AFUDC to CWIP as soon as possible to limit the period during which the Project costs are tracked in a memorandum account earning AFUDC. In its Protest, MPWMD suggests that the Commission lacks the requisite authority to consider California American Water's proposal as part of this proceeding. MPWMD is wrong. The Commission has the authority to grant the relief requested by California American Water in its Application, and as such, the issue is properly within the scope of this proceeding. Requiring California American Water to file a separate application would be a waste of the Commission's resources, as well as the parties to this proceeding. Furthermore, California American Water has already provided notice to its customers that it is asking the Commission to allow it to move the San Clemente Dam memorandum account

² As a result, DRA/Intervenor testimony would be due July 9, 2007, California American Water's rebuttal testimony would be due July 24, 2007, the evidentiary hearings (if necessary) would be held on August 6, 2007, opening briefs would be due on August 20, 2007, and reply briefs would be due on August 27, 2007.

balance, including AFUDC, into rate base when the San Clemente Project becomes more certain. From a due process standpoint, all required bases have been covered and the Commission can move ahead to a decision on the full merits of this Application.

2. The Calculation of California American Water's AFUDC Interest Rate for the Clemente Dam Project Can Be Properly Addressed in This proceeding.

Contrary to MPWMD's suggestion that the calculation of California American Water's AFUDC interest rate should be addressed through a rulemaking of general applicability, the determination of California American Water's AFUDC rate for the San Clemente Dam Project can and should be properly addressed in the context of this Application proceeding. Even though the interest rate of California American Water's AFUDC for the San Clemente Dam Project could inform cases for other water utilities down the road and send a positive signal regarding the Commission's support of necessary investments, the requested relief is not a regulation applicable to all Commission-regulated water utilities. An AFUDC rate adopted through a rulemaking, if such a thing exists, would apply to an entire class of utilities rather than a single project such as the San Clemente Dam Project. Pursuant to Rule 6.3 of the Commission's Rules of Practice and Procedure, any person may petition the Commission under Public Utilities Code Section 1708.5 to "adopt, amend, or repeal a regulation. The proposed regulation must apply to an entire class of entities or activities over which the Commission has jurisdiction and must apply to future conduct." California American Water's proposed AFUDC rate, if authorized by the Commission, would apply only to California American Water's San Clemente Dam Project and would not apply to other water utilities, and therefore is appropriate for consideration in this Application proceeding.

3. Under the Commission's Standard Ratemaking Practices, the Recovery of AFUDC Will Be Based Only Upon Those Costs that are Recoverable.

Contrary to MPWMD's claim, California American Water will not seek to recover AFUDC on expenditures that have been excluded from recovery. As with any cost transferred into rate base for ratemaking purpose that will earn a return, the Commission will have the opportunity to review California American Water's Project costs for reasonableness. Under the

Commission's standard ratemaking practices, California American Water's AFUDC for the San Clemente Dam Project that will be allowed in plant in service will be calculated based upon only those costs that are deemed prudent and recoverable.

III. CONCLUSION

DRA's and MPWMD's Protests are without merit. For the reasons set forth above, the Commission should reject the recommendations set forth in DRA's and MPWMD's Protests and grant the relief requested in the Application. Requests by DRA and MPWMD to exclude the key issues in the proceeding should be disregarded. As set forth above, the Commission should proceed expeditiously so that it may issue an order granting California American Water's Application.

Dated: April 5, 2007

STEEFEL, LEVITT & WEISS
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By: /s/ Lori Ann Dolqueist
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PROOF OF SERVICE

I, Cinthia Velez, declare as follows:

I am employed in the City and County of San Francisco, California. I am over the age of eighteen years, and not a party to the within cause; my business address is STEEFEL, LEVITT & WEISS, One Embarcadero Center, 30th Floor, San Francisco, California 94111-3719. On April 5, 2007, I served the within:

California-American Water Company's Reply to Protests of the Division of Ratepayer Advocates and Monterey Peninsula Water Management District

on the interested parties in this action by placing a true copy thereof in a sealed envelope, addressed as follows:

Please see attached Service List

- ☒ **(BY PUC E-MAIL SERVICE)** By transmitting such document electronically from Steefel, Levitt & Weiss, San Francisco, California, to the electronic mail addresses listed above. I am readily familiar with the practice of Steefel, Levitt & Weiss for transmitting documents by electronic mail, said practice being that in the ordinary course of business, such electronic mail is transmitted immediately after such document has been tendered for filing. Said practice also complies with Rule 1.10(b) of the Public Utilities Commission of the State of California and all protocols described therein.
- ☒ **(BY MAIL)** By placing such document(s) in a sealed envelope, with postage thereon fully prepaid for first class mail, for collection and mailing at Steefel, Levitt & Weiss, San Francisco, California following ordinary business practice. I am readily familiar with the practice at Steefel, Levitt & Weiss for collection and processing of correspondence for mailing with the United States Postal Service, said practice being that in the ordinary course of business, correspondence is deposited in the United States Postal Service the same day as it is placed for collection.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on April 5, 2007 at San Francisco, California.

/s/ Cinthia A. Velez

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